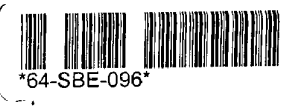
1. SOURCE OF
2. INTEREST



BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
THE INN AT LA JOLLA, INC.)

Appearances:

For Appellant: Robert C. Brockway, Attorney at Law

For Respondent: Crawford H. Thomas, Associate Tax Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of The, Inn at La Jolla, Inc., against proposed assessments of additional franchise tax in the amounts of $280.72, $290.56, $922.25 and $1;290.23 for the income years ended June 30, 1958, 1959, 1960 and 1961, respectively.

Appellant, a California corporation, principally, engaged in a California motel operation, with home office and records here, commenced investing in Texas oil lease activities during the income year ended June 30, 1958. Appellant incurred net losses in these activities during the four years under consideration and deducted the losses in determining its franchise tax liability. Respondent disallowed the deductions.

Appellant is completely controlled by Mr. Robert L. Haniman, a California resident,, Haniman and his wife owning 98.6 percent of appellant's stock. There are no employees, officers or directors outside this state. While contracts are said to be negotiated and entered into in California, Haniman made numerous trips to Texas in order to negotiate the oil lease contracts,

Complete evidence concerning the agreements with the oil lessees is lacking, However, itis known that appellant advanced money to acquire a one-sixteenth, or 'lesser, interest 'ineachof several oil leases, the money to be used by the operating lessee to drill a well to a certain depth and to pay the lease expense. Appellant's investment was lost if the well was dry. Appellant apparently paid its proportionate share of additional costs if the well turned out to be a producing well, and if there were profits appellant was entitled to its proportionate share. On the franchise tax returns for the years in dispute appellant specifically answered "no" to the question whether it was a member of any joint venture or partnership.

Haniman, in testifying, referred'to the outlays as "investments ." He said that technically the corporation was a "non-working partner." Nevertheless his testimony also established that the operating lessee had sole management and control of the operation, that it was "their business," and 'that the only control by appellant was an option not to participate'financially in subsequent wells in a particular lease.

The primary issue is whether the losses from the oil leases are attributable to sources within or to sources without this state,, Under section 25101 of the Revenue and Taxation Code, only income derived from sources within California is includible in the measure of the franchise tax. Correspondingly, losses from out-of-state sources are not deductible, The parties agree that there was no unitary business conducted within and without California, so a separate accounting method is appropriate. (See Butler Bros. v. McColgan, 17 Cal, 2d 664 [111 P.2d334], aff'd,315U.S. 501 [86 L. Ed. 991].)

If appellant's interest in the oil leases is a real property interest the loss is attributable to an out-of-state source and is not deductible. (Rev. & Tax. Code, § 23040; Cal. Admin. Code, tit. 18, reg. 23040(a).) The nature'of a property interest is determined by the place where the property is located, (Commissioner v. Skaggs, 122 F.2d 721.) In Texas we find that an oil lessee holds an interest in real property (Stephens County v. Mid-Kansas Oil & Gas Co,,. 1.13 Tex. 160 [254 S.W. 290]; Texas Co. v. Daugherty,107 Tex. 226 [176 S.W. 7173) and that the conveyance. of part of the lessee's interest

also conveys to the recipient an interest in real property. (Tennant v. Dunn, 130 Tex. 285 [110 S.W. 2d 53]; Prince Bros. Drilling Co. v. Fuhrman Petroleum Corp. (Tex. Civ. App.) 150 S.W. 2d 314; Hammdnds v. Commissioner, 106 F.2d 420,)

We have noted the fact that: Mr. Haniman has referred to appellant as a "non-working partner" under the oil lease arrangements. The interpretation of whether a partnership was created is governed by the law of the place of performance, Texas. (Cal. Civ. Code, § 1646; Young v. Pearson, 1 Cal. 448,) Without deciding whether our conclusion as to the source of the losses should be different if a partnership existed, it is our opinion that: no such relationship was created.

Applyfng Texas law we find that: in the case of. Berchelmann v. Western Co, (Tex. Civ. App.) 363 S.W. 2d 875, two partners operating under the name Texita entered into an agreement with other defendants who, with Texita, held fractional... interests of all the working interest under an oil and gas lease. Pursuant to the agreement Texita possessed and exercised exclusive control of development and operations of the lease. Texita was to do the operating and drilling and bill the other' defendants for their proportionate share of the expenses which were to be remitted to Texita, Texita was known as the "operator,'! the others as "'don-operators." In an action by creditors to recover for materials 'and services the dther defendants were held not liable as partners. The agreement was found not to contain the basic -elements of sharing of liability, control, risk and profits, along with the elements of agency, necessary to constitute either a mining partnership or ordinary partnership,. 'To the same effect is Youngstown Sheet & Tube Co. v. Penn (Tex. Civ. App.) 355 S.W. 2d 239, modified in 363 S.W. 2d 230 as to another issue only. Another Texas case indicating that a partnership does not: exist under somewhat similar facts is U. S. Truck Lines v. Texaco, Inc. (Tex. Civ. App.) 337 S.W. 2d 497,

Appellant also relies on our opinion in the Appeal of Gilmore Oil Co,, Cal,, St. Bd, of Equal., Nov. 15, 1939, where net profits from the sale of out-of-state oil leases were held to be-subject: to the California Bank and Corporation Franchise Tax Act. At that time, however, section 10 of the act provided that if the entire business of the corporation is done within this state, the tax shall be according to or measured by its entfre net income. It was 'found that Gilmore's

entire business was done in this state. Today, unless the property is an integral asset of a unitary business conducted partly in California, the income and expenses attributable to property located outside this state do not enter into the calculation of the franchise tax, whether or not business is wholly done in this state, (Rev. & Tax. Code, §§ 23040 and 25101.)

Appellant's argument that a resident individual could include the out-of-state loss ignores the fact that as to a resident individual the tax is upon the entire net income (Rev. & Tax. Code, § 17041) while as to a corporation the tax is measured only by the net income derived from California sources. (Rev. & Tax. Code, § 25101.)

Appellant contends that it should be relieved of interest on the tax because respondent refrained from acting on its protest for a considerable time, awaiting certain court decisions which, as it developed, were not considered controlling.

Section 25901 of the Revenue and Taxation Code provides, in mandatory language and without exception, for the payment of interest at the rate of 6 percent a year on any amount of unpaid tax. After filing its protest, appellant could have prevented the accrual of interest by paying the amount in issue at any time, without sacrificing its right to a refund together with 6 percent interest in the event of a determination in its favor. (Rev. & Tax. Code, §§ 26078, 26080.) With this alternative available, appellant has no ground for objecting to the payment of interest.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the

action of the Franchise Tax Board on the protest of The Inn at' La Jolla, Inc., against proposed assessments of additional franchise tax in the amounts of $280.72, $290.56, $922.25 and $1,290.23 for the income years ended June 30, 1958, 1959, 1960 and 1961, respectively, be and the same is hereby sustained and that interest accrue until the date of payment.

Done at Sacramento California, this 18th day of December, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman

John W. Lynch, Member

Richard Nevins, Member

Geo. R. Reilly, Member

_______________, Member

ATTEST: [signature], Secretary